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SUBJECT: Regulatory Climate in South China: Not All Investment Is Created Equal

REF: Beijing 912

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¶1. (SBU) Summary: Regulatory issues, particularly those relating to administrative discretion, are the biggest impediments to foreign direct investment (FDI) in South China, according to legal professionals and businesspeople. Foreign investors encounter more obstacles when establishing local operations than their domestic counterparts. This trend is likely to continue in 2008, despite the recent adoption of equal-treatment tax regulations. Environmental regulations, in contrast, are expected to be enforced, without discrimination, between domestic and foreign enterprises. End Summary.

Equity to Debt Limitations

¶2. (SBU) According to David Buxbaum, a long time resident of South China, managing partner of Shenzhen-based Anderson & Anderson LLP and one of the most savvy lawyers on China's legal framework, foreign companies in the Pearl River Delta are granted fewer benefits, and this is less consistency in their treatment, than their domestic counterparts. The discriminatory treatment is particularly evident in the implementation of equity-to-debt regulations. Buxbaum said Chinese corporations can negotiate and meet registered capital requirements much easier than foreign companies, both at the local and provincial levels. Furthermore, the recently adopted real estate regulations targeting foreign investors have been consistently enforced, thus requiring all foreign-invested enterprises' (FIEs) property investment to be capitalized at a minimum of 50 percent of total estimated costs. Buxbaum noted that since foreigners comprise such a small segment of the real estate market, the actual effect of this measure on the entire market is primarily psychological. Essentially, the government is trying to signal - especially to those who don't understand how the market is segmented - that the blame for recent real estate hikes lies with foreigners. In so doing, it has added another unnecessary layer of discriminatory regulation to foreign investment.

Tax Regulations

¶3. (SBU) On January 1, 2008, the income tax rate for all companies in China, both foreign and domestic, will equalize at 25 percent. Most domestic enterprises will see a tax cut, while most FIEs will see their taxes increase. To prepare for the change, many large and already established FIEs and potential FIEs in the Pearl River Delta

(PRD) have re-structured their operations to ensure their income is taxed as that of a Hong Kong entity this allows them to qualify for the lower tax rate of 17.5 percent. As reported in its May 2007 issue of China Briefing, the regional consultancy Dezan Shira & Associates expects that many foreign small-to-medium enterprises (SMEs), in contrast, may look to invest in other countries because they are unable to meet the tax burden.

¶4. (SBU) Although business tax regulations will soon be uniform on paper, enforcement will likely remain uneven, according to Vivian Desmonts, regional partner for South China's leading European Law Firm, DS Law Firm. Despite recent improvements, said Desmonts, tax fraud remains a popular national "sport." Foreign investors are not particularly inclined to participate, however, because they are investigated with far more scrutiny. In south China, where central investigatory bodies have only an indirect influence, local relationships can rather easily lead to the acceptance of "cooked" accounting books, since the company representative will often have a relationship or indirect connection with the auditing body. Domestic firms, therefore, will often retain an advantage by consistently underreporting taxable income.

Tax Incentives - Not Yet Westward Bound

¶5. (SBU) China's underdeveloped western regions will likely continue to use preferential tax policies to attract FDI, despite the expiration of most other tax holidays, according to Dezan Shira. Nevertheless, legal experts and business professionals in South China remain skeptical that these incentives will lure investment out of Beijing, Shanghai, and Southeast China. A local businessperson and several legal experts said China is ten or more years removed from being able to attract large foreign investment

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into its western provinces.

Mergers & Acquisitions (M&A)

¶6. (SBU) Many foreign invested companies in the PRD are now attempting to tap directly into the China market instead of simply re-export. This development has been accompanied by an expansion in M&A activity, designed specifically to open up distribution channels. Although the M&A regulations issued by the Chinese government in September 2006 helped to facilitate this transition, legal experts in south China still complain of discriminatory treatment. This includes a lack of transparency in the interpretation and enforcement of specified restrictions with regard to Chinese-targeted asset acquisitions, as well as unclear prohibitions on merger agreements. And while at least one practitioner of a well-established law firm in the region attributes this to the natural growing pains of a law in its infancy, others are more critical and believe it to be yet another indication of centrally-driven protectionism (reftel).

¶7. (SBU) According to Xinhua News, the second draft of the Anti-Monopoly Law was recently submitted to the National People's Congress Standing Committee and calls for the examination of all M&A cases related to national security. This marks the first time that such a provision has been enshrined in law. Consensus among business and legal professionals is that this is retaliation for CNOOC's failed bid of UNOCAL in 2005. Harley Seyedin, President of AmCham/South China and CEO of First Washington Group - which established the first Western majority-owned power plant in South China - worries about the potential for selective enforcement. The broad language of the law neither stipulates what "examination" entails nor does it specify which cases might qualify as "related to national security". All told, it appears to provide little encouragement to foreign investors planning to engage in large M&A transactions, particularly in those sectors currently controlled (and likely held for continued domination) by big state-owned enterprises.

Environmental Regulations

¶ 8. (SBU) Although enforcement of environmental regulations remains uneven at the local level, officials are paying increasing attention to the issue. According to Chun Hua Li, Chief Representative for McCandlish Holton PC, the promotion of government officials is now correlated, at least in part, to their work in promoting environmental policies. This has led to more consistent pre-assessment reviews for all investors, both foreign and domestic.

Some companies, though, have had to alter previously compliant operations to reach present standards. Mr. Li and other attorneys in the PRD counsel their clients to exceed all necessary regulations to ensure long-term compliance.

Comment: Challenges Still Lie Ahead

¶ 9. (U) Although the regulatory climate in the PRD has improved significantly, numerous challenges remain. Foreign investors continue to encounter discriminatory treatment in areas such as real estate and equity-to-debt ratios. Ironically, the emergence of an equal-treatment business tax will likely prove discriminatory to foreign enterprises because domestic companies are less compliant and it's easy for the government to point to foreign companies to deflect their own inaction on domestic concerns. Companies, many of which will probably continue to shift to Hong Kong corporate residency in 2008, will need to consider long-term compliance in an increasingly sensitive environmental regulatory climate, a trend which has already begun to take shape within the region.

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